

# **An Update on the Economy of Palau**

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## **I. Introduction**

In the last 3-4 years, the same factors that have beset the economies of Guam, Commonwealth of the Northern Mariana Islands (CNMI) and, to a certain degree, Hawaii, have hindered economic growth in Palau. Beginning with the Asian financial crisis in 1997-98, the West Pacific economies entered what turned out to be a relatively long period of stagnation and decline. Just about the time that a weak but discernable recovery was beginning to take shape in the Western Pacific economies and Hawaii in late 2000 to mid-2001, the terrorist attacks on New York and Washington on September 11, 2001 derailed it. The attacks and their aftermath not only disrupted air traffic in the United States but substantially affected travel from Japan, especially to the United States and U.S. affiliated destinations in the Western Pacific.

Japan is a major supplier of tourists not only to Guam and CNMI but Palau as well, and the economic and financial impact of reductions in Japanese travel and spending extends to this market. However, since Palau is not as dependent on Japanese tourists as Guam and CNMI are, where Japanese tourists make up to 70-75 percent of all tourists, the impact of Japanese travel dollars is smaller but not insignificant. Although Palau did not suffer from debilitating natural disasters as Guam and, to a lesser extent, CNMI, did in 2000-2002, the cumulative impact of global and regional economic and security difficulties affecting regional tourism caused Palau's travel industry to suffer in ways similar to the rest of the West Pacific's.

In the meantime, what has lessened the negative impact of losses of tourist dollars in the last few years has been the ongoing work on the country's major public infrastructure projects. The largest of these is the so-called Compact Road, which is under construction. It was included as a special economic development project in the financial package of Palau's Compact of Free Association with the United States. The 53-mile long two-lane highway around Palau's main island, Babeldaob, will be an important addition to Palau's infrastructure and basis for economic growth.

Another major project nearing completion is the national capital on Babeldaob, largely funded by soft loans from Taiwan. Major projects completed recently are the bridge connecting Babeldaob to Koror (funded by Japan) and the airport terminal building which now makes Palau's airport terminal facility comparable to other small but modern and functional facilities of the region. With the Compact Road's completion, Palau's major public infrastructure projects that started after the Compact of Free Association was signed in 1994 will have been completed.

A major private project completed recently is the Papago International Resort near the airport area. Completed in late 2002, the resort has 100 rooms and other

amenities, targeting mainly Taiwanese tourists. The capital for the project came from Taiwan, along with management, and labor is provided by China. Beside the well-known Palau Pacific Resort and Palasia Hotel Palau, Koror now has three major hotels with 100 or more rooms and world-class facilities and services. Putting all hotel and motel rooms together, Palau now has a total room count of just over 1,000. That counts is still much smaller than CNMI's more than 4,000 and Guam's 8,000-9000 rooms, but a big increase from a decade ago.

## II. The Compact Road and Economic Development

The Compact Road is scheduled for completion in 2005-06, depending on various factors, of which weather seems to be one of the most influential. The texture of the soil in certain areas through which the Road must pass presents challenges from time to time. The type of soil that occurs in some areas retains moisture and causes landslides in steeply-sloping areas during heavy rains, which occur frequently in Palau. The landslides delay the ongoing work and may even force rerouting parts of the road or drainage ducts and other adjustments. Still, the road is expected to be finished within the next two years.

With completion of the Compact road and these other infrastructure projects, Palau is to enter a new phase of economic growth with better production and distribution possibilities which would lead to greater self-sufficiency from within. Babeldaob, the region's second largest island after Guam accounting for nearly 80 percent of Palau's landmass, has so far remained pretty much untouched; opening the island's landmass to commercial possibilities and connecting to urban Koror appears to hold great promise.

The question is what type of production and distribution activities would come into being with completion of the Compact Road that would make a difference in Palau's economic development evolution. Its potential contribution to economic growth and development have not been studied, but it appears that there is greater expectation attached to the Road than what it may contribute, at least in the short run.

The road will connect the outlying areas of Babeldaob to Koror and the new national capital. It will also make it possible for individuals and household in Koror, which is congested, to acquire land on Babeldaob for personal and business uses. Migration from Koror to the various points on Babeldaob will create its own issues as there is little other infrastructure to support urbanization of the island. At least initially, the Road may not turn out to be the economic and financial miracle it is often expected to be. Nor is there much of a commercially viable economy on the island that the Road would connect to Koror.

One of the most talked about potential projects is a golf course as part of a luxury condominium project that may attract affluent foreign visitors and part-time residents. To enable part-time foreign residents to claim legal residence in Palau, existing law may have to be changed. Even with the change in law, there is no assurance that wealthy foreign residents will rush to Babeldaob, whose only major assets will be a road around the island and a brand new national capital. There has yet to be a plan for other infrastructure the island would need to fuel economic growth of a magnitude that would have national impact.

There have also been discussions about the Road encouraging farming and eventually commercial agricultural production. Establishing an agricultural industry in an

area which does not have such a history will be a challenge. A useful example in this regard is the establishment of a beef industry in Vanuatu. It took decades of work and significant sums of money, in addition to land and other facilities to make it commercially viable. An important factor in making Vanuatu's beef industry viable has been its success with obtaining export license to Japan. More recent successes with obtaining export licenses to Australia and New Caledonia, both established beef producers themselves, have added to Vanuatu's credibility as a commercial beef producer. The important ingredient in Vanuatu's success with commercial beef production is access to export markets, since domestic demand for beef is not sufficient to keep the enterprise going.

### III. Focus on Tourism

Among the perennial issues in the context of economic development in the Pacific is economic diversification. The region's geography and physical isolation limit the range of activities that can beneficially be undertaken. However, one of the industries most Pacific islands share, with varying degrees of commercial success, is tourism. This is true as much in Palau as anywhere in the Western Pacific and Palau's ecosystem certainly is a major asset for tourism.

Given present conditions and Palau's established comparative economic advantages, a more practical argument for economic growth and development in the immediate future is focus on tourists, both divers and others. Aiding Palau's economic recovery, just as it does Guam's, CNMI's and Hawaii's, is economic recovery in Japan which still supplies about half of Palau's tourists. The other half consists of Taiwanese and others, including American and European divers and business travelers. Based on figures for late last year and earlier this year, Palau expects about 70,000 tourists this year. That figure would put the total near the previous peak in 1996-97.

Palau is a small economy. It needs, proportionately, smaller doses of capital and skills to reinvigorate it. Meanwhile, improving tourism and tourist infrastructure should make it possible to pursue other roads to growth, development and prosperity.